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U.S. MARKET COMMENT: THE CURRENT STATE OF PLAY

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The Current State of Play

The major U.S. equity market indexes peaked in March 2000, and subsequently declined from 67.5% (Nasdaq) to 27.8% (S&P 500). However, the relatively narrow and more cyclical Dow Jones Industrial Average (DJIA) peaked in mid-January and subsequently declined 19.9%. To date, the low for most indexes was recorded in late March (DJIA) or early April (S&P 500 and Nasdaq), since which point they have recovered from 11.0% (S&P 500) to 31.8% (Nasdaq) (see Table A). Since World War II, there have been nine bear markets in the S&P 500, with an average decline of 30.5%, lasting an average of 16 months. If we have already seen the low point of this most recent decline, it therefore ranks as a relatively modest affair by bear market standards, with a drop of 27.8% over 12 months.

Despite the severity of the peak-to-trough declines in the Nasdaq and S&P 500, it is hard to make the case that most equity investors have been put through the wringer of a serious bear market. As Tables B and C indicate, 27% of S&P 500 constituent stocks and 57% of Nasdaq constituents have declined at least 30% from their peak prices in the past 52 weeks. However, 69% of S&P 500 stocks and 80% of Nasdaq stocks have *increased* in price at least 30% during the same period—data inconsistent with a generalized bear market during which relatively few issues would achieve such gains, while far more would have suffered losses in excess of 30%.

When one looks at reasonably diversified portfolios, returns for the fiscal year ended June 30 probably fall somewhere between -9.5% and -7.4% (see Table D). (These are ballpark estimates, since they incorporate educated guesses as to the returns of venture capital, non-venture private equity, real estate, and marketable alternatives). Although these numbers may be painful in contrast to the spectacular returns of recent years, they are hardly disastrous—if this is the worst of the post-boom bust, we should all breathe a sigh of relief.

Among stock market indicators, the I/B/E/S summary of analysts' consensus earnings estimates shown in Table E indicates a current expectation of -7% growth in S&P 500 earnings in 2001 (down from January's estimate of +6.1%); second quarter earnings, however, have declined almost 18% compared to the same period last year. Analysts still expect earnings to snap back strongly in 2002; although the absolute level of next year's S&P 500 estimated earnings has dropped from February's forecast of $68.19 to the current forecast of $62.52, the percentage increase relative to 2001 estimated earnings has gone up, from 16.98% to 19.38%, as a result of more rapid reductions in expectations for this year.

Almost 36% of the S&P 500 (weighted by capitalization) still has a P/E ratio of 30 or more—down from 60% at the end of 1999, but still very high by historical standards. Only 24% of the S&P 500 has a P/E of 16 or less, although the long-term average P/E of the entire S&P 500 is about 16 (see Table F).

Indeed, whether measured on a trailing basis or on the basis of 12-month forward estimated earnings, the P/E of the S&P 500 remains significantly higher than the long-term average, implying that plenty of risk persists in the market if analysts estimates of next year's earnings prove too optimistic (which they usually do). (See Table G).

Despite the market's decline, insider selling has accelerated to a very heavy rate (especially in Nasdaq-listed stocks), which should give pause to those analysts confidently predicting a powerful rebound in earnings. Meanwhile, investor sentiment is neutral—about evenly divided between bulls and bears—and mutual fund cash remains at relatively low levels by historical standards, both of which suggest that investors have by no means given up on equities.

Meanwhile, the capital markets appear to be discounting a normal cyclical slowdown that will respond to Fed stimulus. Since the Fed started cutting rates in early January, bank stocks have outperformed, bond issuance has risen dramatically, credit spreads have narrowed, and the yield curve slope has steepened. In the past year, West Texas crude oil has dropped from $32.50 per barrel to $26.24 per barrel, while home prices have risen sharply, and tax repayments amounting to 1% of GDP on an annualized basis are about to arrive in consumers mailboxes. Although business capital expenditure remains at a dead stop, consumers appear ready, willing, and able to keep spending, despite being heavily indebted.[1] The bond market seems especially convinced that economic revival is imminent, while the stock market evinces much less certainty, with investor sentiment wishy-washy, technical trends relatively weak, and insider selling ominously brisk, as noted above.

The Longer Term Outlook

It's anyone's guess whether we've seen the lows of this bear market, or whether worse is yet to come. Longer term, however, the U.S. stock market is unlikely to deliver returns anywhere close to those most investors still profess to expect. Future returns are, roughly speaking, implicit in current prices, just as bond returns are implicit in current bond yields; and U.S. equities are priced to deliver below average returns. With the P/E of the S&P 500 on the basis of 12-month forward earnings at about 22, the Achilles' heel of the equation is the denominator. Analysts' earnings forecasts should be treated with profound skepticism, especially since the S&P 500 has been reconstituted as an index dominated by growth stocks,

[1] As Table H indicates, the current level and recent growth of debt in the economy is less alarming when expressed in real rather than in nominal dollar terms.

earnings estimates for which have proved so positively biased as to be worthless.[2] Among the growth stocks comprising the Nasdaq 100, 38 have negative earnings over the past 12 months, while 62 have positive trailing 12-month earnings. The P/E for those 62 is now 64, suggesting that tech-stock investors—battered though they may be—have by no means accepted the market's message that technology is a cyclical growth sector in which fat profit margins are inevitably slashed as each new innovation becomes a commodity.

None of this mattered when the equity markets were riding a wave of positive momentum. Now this momentum has crested, however, and cheerleader analysts have been largely discredited, investors will increasingly tend to focus on bottom-line profitability and to reprice equities on the basis of hard-nosed assumptions about sustainable real earnings growth in a highly competitive marketplace. Unfortunately, analysts' current expectations for future earnings growth appear to be extrapolated from recent history, despite repeated evidence of the unreliability of this approach. In the past decade (1991-2000), the annual real earnings growth of the S&P 500 was 6.5%—the fourth best decade of the entire twentieth century, and the best ten years since 1947-56. It is simply improbable that such growth will persist for a second decade, especially with the economy starting from a position of substantial over-capacity and excessive indebtedness, but equity market valuations seem to incorporate such an assumption, rather than anything close to the longer-term average annual real growth rate of 2.1%. As Peter Bernstein has recently written, "what are we to make of current 3-5 year consensus earnings forecasts for the S&P 500 clustering in the double-digit zone of 15% and even more? . . . Real earnings growth over spans from five years upward averages just 2% a year at the most . . . To go from two percent or so real growth at best to double digit nominal growth implies a rate of inflation so powerful it would drive earnings multiples way down into single digits. Who needs that?"[3]

Although we suspect, on balance, that the Fed's aggressive rate cutting will eventually succeed in rousing the market from its current funk, we therefore remain troubled by the risks implicit in persistently high market valuations, and by the optimistic earnings expectations that must be realized for equities to generate even average returns over the next decade.

[2] See "The Level and Persistence of Growth Rates" by Louis K.C. Chan, Jason Karceski, and Josef Lakonishok, NBER Working Paper 8282, May 2001, which demolishes the delusion that analysts can predict future growth rates with any degree of accuracy.

[3] "The Future As We Don't Know It," *Economics and Portfolio Strategy*, June 15, 2001.

Table A

U.S. EQUITY INDEXES

Index	Peak	Date	Low since Peak	Date	Peak-Low % Decline	Price Close June 30, 2001	% Rise from Low to June 30, 2001
Dow Jones Industrial Average	11723.0	1/14/00	9389.5	3/22/01	-19.9	10502.4	11.9
S&P 500	1527.5	3/24/00	1103.3	4/4/01	-27.8	1224.4	11.0
Nasdaq Composite	5048.6	3/10/00	1638.8	4/4/01	-67.5	2159.2	31.8
Dow Jones U.S. Total Market	1879.4	3/24/00	1285.8	4/4/01	-31.6	1450.9	12.8
Dow Jones U.S. Large Cap	1857.0	3/24/00	1230.7	4/4/01	-33.7	1374.7	11.7
Dow Jones U.S. Mid Cap	1989.6	3/24/00	1581.7	4/3/01	-20.5	1817.0	14.9
Dow Jones U.S. Small Cap	1933.9	3/9/00	1264.5	4/4/01	-34.6	1545.8	22.3
Dow Jones U.S. Large Cap Growth	2291.7	3/23/00	1011.4	4/4/01	-55.9	1216.0	20.2
Dow Jones U.S. Large Cap Value	1411.3	5/13/99	1066.9	2/25/00	-24.4	1295.8	21.5
Dow Jones U.S. Small Cap Growth	2723.5	3/9/00	1188.4	4/4/01	-56.4	1585.1	33.4
Dow Jones U.S. Small Cap Value	1300.8	6/5/01	1248.7	6/25/01	-4.0	1291.0	3.4

Sources: Datastream International and Dow Jones & Company, Inc.

Note: Returns based on price change only.

Table B

MAJOR EQUITY INDEXES DECLINING 20%, 30%, 40%, 50% AND 90% FROM 52-WEEK HIGH

July 1, 2000 - June 30, 2001

Index	Equities		20%+	30%+	40%+	50%+	90%+
S&P 500		Totals:	199	136	86	64	5
Count =	500	Percent:	40%	27%	17%	13%	1%
NYSE		Totals:	731	484	298	202	10
Count =	1,906	Percent:	38%	25%	16%	11%	1%
Nasdaq Exchange		Totals:	2739	2373	2045	1731	326
Count =	4,158	Percent:	66%	57%	49%	42%	8%
AMEX		Totals:	393	320	258	189	21
Count =	632	Percent:	62%	51%	41%	30%	3%

Source: Standard & Poor's Compustat.

Notes: NYSE, AMEX, and Nasdaq Exchange are common stocks only, and exclude ADR's, preferred stock, and mutual funds. NYSE, AMEX, and Nasdaq Exchange constituents are as of July 3, 2001.

Table C

MAJOR EQUITY INDEXES INCREASING 20%, 30%, 40%, 50% AND 90% FROM 52-WEEK LOW

July 1, 2000 - June 30, 2001

Index	Equities		20%+	30%+	40%+	50%+	90%+
S&P 500		Totals:	413	344	264	196	59
Count =	500	Percent:	83%	69%	53%	39%	12%
NYSE		Totals:	1566	1346	1089	882	386
Count =	1,906	Percent:	82%	71%	57%	46%	20%
Nasdaq Exchange		Totals:	3676	3323	2969	2592	1545
Count =	4,158	Percent:	88%	80%	71%	62%	37%
AMEX		Totals:	514	451	391	332	198
Count =	632	Percent:	81%	71%	62%	53%	31%

Source: Standard & Poor's Compustat.

Notes: NYSE, AMEX, and Nasdaq Exchange are common stocks only, and exclude ADR's, preferred stock, and mutual funds. NYSE, AMEX, and Nasdaq Exchange constituents are as of July 3, 2001.

Table D

TOTAL RETURN (%) SIMULATION OF FOUR DIFFERENT PORTFOLIOS
Year Ended June 30, 2001

	Asset Allocation (%) as of June 30, 2000									1 Year
Portfolio	U.S. Equity	Non-U.S. Equity	Fixed Income	Cash	Real Estate	Venture Capital	Private Equity	Hedge Funds	Absolute Return	Imputed Total Return*
1	35.0	15.0	18.0	3.0	4.0	10.0	5.0	5.0	5.0	-9.0
2	45.0	13.0	23.0	4.0	3.0	4.0	2.0	4.0	2.0	-7.7
3	50.0	10.0	25.0	5.0	0.0	5.0	5.0	0.0	0.0	-9.4
4	50.0	15.0	25.0	5.0	5.0	0.0	0.0	0.0	0.0	-7.4

*The following indexes were used for each asset class to simulate the Total Return numbers:

U.S. Equity	Dow Jones Total Market Index
Non-U.S. Equity	80% Morgan Stanley Capital International EAFE Index, 20% Morgan Stanley Capital International EMF Index
Fixed Income	Lehman Brothers Aggregate Bond Index
Cash	91-Day Treasury Bills
Real Estate	75% [Preliminary] NCREIF Property Index, 25% NAREIT Equity Index
Venture Capital	[Preliminary] Cambridge Associates LLC U.S. Venture Capital Index®
Private Equity	[Preliminary] Cambridge Associates LLC U.S. Private Equity Index®
Hedge Funds	[Preliminary] Cambridge Associates LLC Investment Manager Database
Absolute Return	[Preliminary] Cambridge Associates LLC Investment Manager Database

Table E

I/B/E/S SUMMARY

As of June 30, 2001

	12-Month Forward Earnings Expectations	2001 Earnings Estimates	Annual Growth Rate	2002 Earnings Estimates	Annual Growth Rate	2nd Q 2001 EPS	2nd Q 2001 Y/Y% Growth
Jan-00	58.09	---	---	---	---	---	---
Feb-00	59.31	67.87	15.96	---	---	---	---
Mar-00	60.02	67.19	14.70	---	---	---	---
Apr-00	60.45	66.84	14.61	---	---	---	---
May-00	61.24	66.78	14.21	---	---	---	---
Jun-00	62.20	67.16	14.49	---	---	---	---
Jul-00	62.32	66.34	13.79	---	---	---	---
Aug-00	62.51	65.66	13.01	---	---	---	---
Sep-00	62.69	65.13	12.68	---	---	---	---
Oct-00	62.55	64.25	11.82	---	---	---	---
Nov-00	61.98	62.93	9.96	---	---	---	---
Dec-00	60.80	61.17	7.86	---	---	---	---
Jan-01	59.51	59.51	6.08	---	---	---	---
Feb-01	59.12	58.29	3.66	68.19	16.98	---	---
Mar-01	58.14	56.49	0.44	66.38	17.51	---	---
Apr-01	56.53	54.01	-4.08	64.07	18.63	12.98	-11.50
May-01	56.56	53.25	-5.43	63.17	18.63	12.57	-14.30
Jun-01	56.60	52.37	-7.00	62.52	19.38	12.04	-17.90

Source: I/B/E/S International. Inc.

Table F

S&P 500 PRICE-EARNINGS RATIOS

		Number of Companies/ Percentage of S&P 500	Percentage of S&P 500 by Market Capitalization
June 30, 2001			
30 and above		122 / 24.4	35.9
16 and below		180 / 36.1	23.5
Median P/E	**18.9**		
December 31, 2000			
30 and above		127 / 27.4	45.0
16 and below		170 / 36.7	16.3
Median P/E	**20.0**		
December 31, 1999			
30 and above		149 / 31.8	60.1
16 and below		163 / 34.8	11.5
Median P/E	**20.4**		
December 31, 1998			
30 and above		144 / 33.3	54.8
16 and below		101 / 23.3	7.7
Median P/E	**23.1**		

Source: Calculated from data provided by Standard & Poor's Compustat.

Notes: Price-earnings ratio analyses exclude companies with deficit or collapsed earnings. Percentages may not total 100% due to missing, incomplete, or not meaningful dat

Table G

U.S. STOCK MARKET VALUATIONS

January 1, 1960 - June 30, 2001

	S&P 500 Peak 03/24/2000	S&P 500 06/30/2001	Average (to 06/30/2001)	Ratio of Peak to Average	Ratio of 06/30/2001 to Average	Percentile Ranking of Peak Valuation	Percentile Ranking of 06/30/2001 Valuation	% Decline in Price Required to Reach Average Valuation
Price-Earnings								
12-Month Trailing Reported Earnings	30.0	27.5 (P)	16.4	1.8	1.7	3%	6%	-40.3%
12-Month Trailing Operating Earnings	28.7	23.3	18.2[1]	1.6	1.3	3%	19%	-21.8%
12-Month Forward Operating Earnings	25.4	21.6	13.2[2]	1.9	1.6	1%	13%	-39.0%
Dividend Yields	1.1	1.3	3.4	0.3	0.4	0%	5%	-61.9%
Price-to-Book	7.6 (P)	6.1 (P)	2.2[3]	3.4	2.7	0%	6%	-63.6%
Ratio of Earnings Yields to 30-year Treasury Yields	0.6	0.6 (P)	1.0	0.6	0.6	5%	11%	-35.4%
Ratio of Dividend Yields to 30-year Treasury Yields	0.2	0.2	0.5	0.4	0.5	1%	4%	-53.8%

Sources: Datastream International, I/B/E/S International, Inc., Salomon Smith Barney, Standard & Poor's, Standard & Poor's Compustat, and *The Wall Street Journal*.

Notes: (P) Preliminary. Data for March 24, 2000 were created by using the closing price on that day. Earnings, dividends, book value, and 30-year treasury yields are from March 31, 2000. Average valuations and percentile rankings are based on quarterly data.

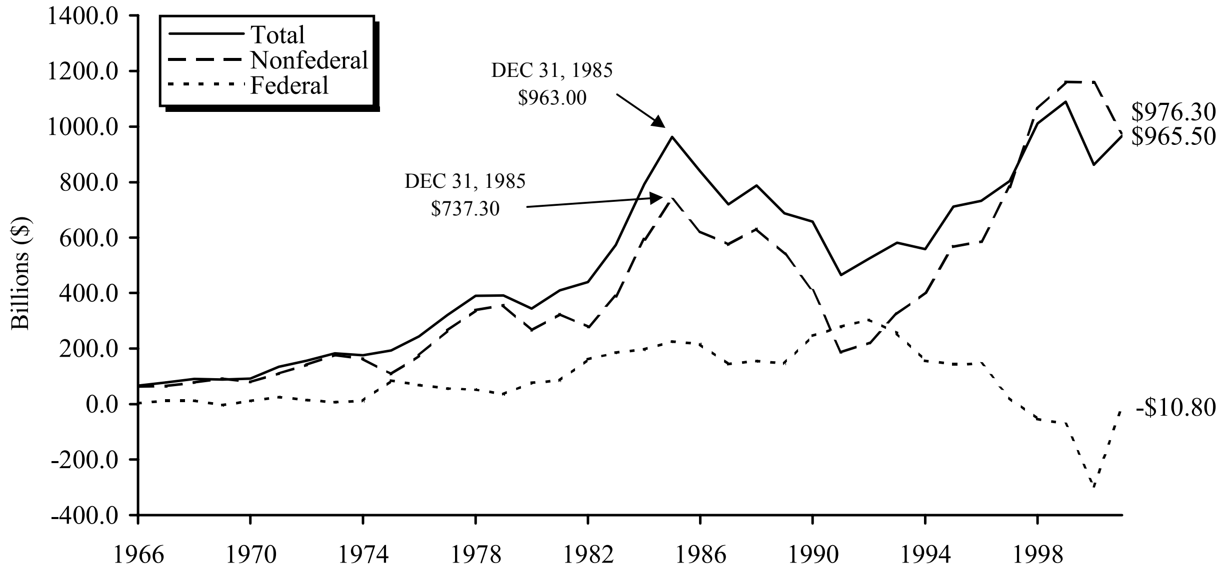
[1] The average is taken from September 30, 1985.
[2] The average is taken from September 30, 1978.
[3] The average is taken from March 31, 1963.

Table H

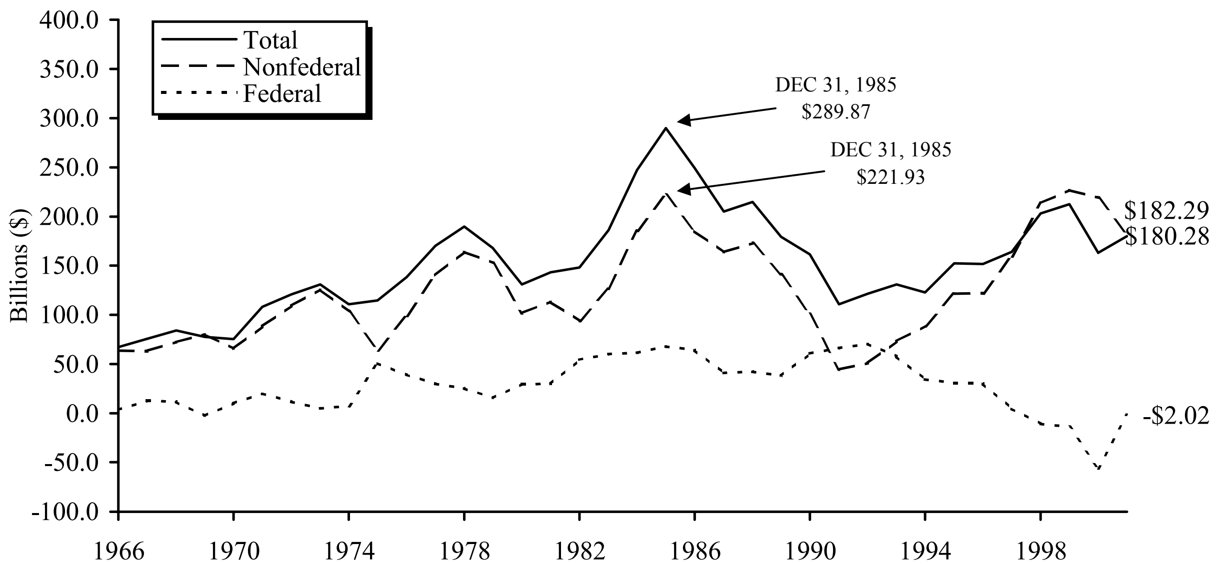
BORROWING OF NONFINANCIAL U.S. SECTORS

1966-2001

Nominal Dollars



Real Dollars



Sources: Bureau of Labor Statistics and Federal Reserve.

Notes: Graph represents annual data. 2001 data are through March. Real data are expressed in 1966 dollars.